CIA/OER/IM 71-37 JORDAN: SOME IMPLICATIONS

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DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

Jordan: Some Implications Of Reducing The Currency Cover

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
February 1971

INTELLIGENCE MEMORANDUM

Jordan: Some Implications Of Reducing The Currency Cover

Introduction

Jordan's financial position has not changed markedly since last September's fighting between fedayeen and government troops. It continues to be weak. After the fighting, Libya and Kuwait suspended their Khartoum aid to Jordan that had totaled $64 million annually. Kuwait resumed monthly payments in December, but again suspended them when fighting flared up anew. Thus Khartoum aid has been reduced to the $41 million supplied annually by Saudi Arabia. The impact of the aid suspension has been cushioned in the short run by a $10 million advance from Saudi Arabia and emergency aid from the United States ($10 million) and elsewhere. Current receipts fall far short of expenditures, however, and a sizable drawdown of Jordan's foreign exchange reserves appears to be in prospect.

On the domestic side, government revenues will be well below expenditures, with the result that the money supply will continue to expand rapidly. The International Monetary Fund (IMF) expects an overall Jordanian budget deficit of about $50 million in 1971 even if Arab aid matches the level of 1970.

With foreign exchange receipts declining because of aid cuts, and the supply of domestic currency

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

increasing because of the budget deficit, Amman will soon be forced to abandon its policy of maintaining 100% foreign exchange backing for the local currency. This policy already commits almost all of Jordan's $255 million in foreign exchange reserves. The government holds that a further reduction in the ratio of foreign exchange to currency would cause a loss of confidence in the Jordanian dinar and lead to a large speculative capital outflow. This memorandum discusses the likely consequences of a decline in the ratio of foreign exchange to currency below the 100% level and of a further drawing down of foreign exchange reserves.

Why a 100% Currency Cover?

1. Jordanian officials assert that the 1967 war and ensuing events, including the September 1970 fighting between government units and fedayeen, have undermined public confidence in the future of Jordan. With this in mind they insist that the major reason people are still willing to hold dinars is that the local currency is backed 100% by foreign exchange.* Because of this, Amman fears that a reduction in the currency cover below 100% would cause a rush to convert dinars into goods and other currencies. This would mean an increase in prices and a rapid decrease of foreign exchange reserves, a fear which is intensified by knowledge that the economy is very liquid. The amount of currency outstanding at the end of 1970 was approximately equal to 45% of the gross national product (GNP).** If demand deposits and quasi-money are added to currency, relatively liquid assets would equal about 70% of GNP; in Syria, for example, this ratio is only 45%. Between 1967 and 1970, the currency supply increased rapidly while output and prices showed little change.

** Backing is maintained only for currency, not for bank deposits denominated in dinars. The 100% cover is maintained as a matter of policy, not law. No legislation, or even announcement, would be required if the cover fell below 100%.*

*** GNP figures are rough estimates and include production in the Israeli-occupied West Bank area.*

2. The modest increase in inflation and capital outflow despite the massive increase in currency in circulation is due partly to the situation in the Israeli-occupied West Bank, where the dinar still circulates. Of the $245 million in dinars outstanding at the end of 1970, nearly 55% -- or roughly $130 million -- was held on the West Bank, although the area presently accounts for only about 40% of Jordanian output. The West Bank's large holdings reflect the closure of Jordanian commercial banks in the area, the West Bankers' apparent reluctance to use Israeli commercial banks, Arab preference for dinars over Israeli pounds, and a net flow of dinars from the East Bank to the West because of the trade balance.

Maintaining the 100% Currency Cover

3. Maintaining a 100% currency cover became difficult only recently. Looking as far back as 1958, the ratio of foreign exchange to currency outstanding at year's end did not fall below 165% until 1969. In fact, in the three years prior to the 1967 war, the ratio of foreign exchange to currency was above 200%. After the 1967 war, however, the gap between the government's domestic revenue and domestic expenditures resulted in a rapid rise in the currency supply. The increase from the end of 1966 to the end of 1970 was about 175%. Foreign exchange reserves increased greatly right after the 1967 war but have fallen since 1969. The ratio of foreign exchange to currency outstanding was approximately 105% at the end of 1970.

4. Maintaining a ratio of foreign exchange to currency of 100% or more through 1971 would appear to be a near impossibility in the absence of increased aid from abroad. Additions to the currency supply probably will match the $40 million increase of 1970, fed by a seemingly unavoidable excess of government domestic expenditures over domestic revenues. We expect foreign exchange reserves will be drawn down because the gap between receipts from exports and aid on the one hand and expenditures for imports on the other almost certainly will widen. The IMF estimates that this drawdown will be about $50 million in 1971, assuming that aid from other

Arab countries continues at the level of 1970. This assumption no longer seems valid, however, since Libya and Kuwait have already suspended their Khartoum aid payments.* While Kuwait may resume its aid payments later this year it seems highly unlikely that under present circumstances Libya will do so.

5. The government has taken some measures to prevent currency cover from falling below 100%, but these measures have been inadequate. They have been directed primarily at reducing the large government budget deficits both by expanding revenues and by reducing expenditures. The government succeeded in reducing expenditures in 1970, a noteworthy feat, but revenues declined despite increases in tax rates. The decline in revenues is attributable to the reduction in economic activity caused by the fighting between fedayeen and government forces. The government also began to permit a limited amount of Jordanian government bonds and notes to be included in the currency cover.

What Happens Below 100%?

6. Despite Amman's deeply felt concern, a decline in the foreign exchange currency cover below 100% in itself may not have much effect on confidence in the dinar. In the last two years the ratio has declined from 168% to approximately 105%, and there has been no apparent decrease in public willingness to hold dinars. The Jordanian government argues that merchants and others with large dinar holdings watch the monetary situation very closely and that a decline in foreign exchange backing below 100% would cause these people to convert their holdings in progressively greater amounts, bringing on a financial panic. However, it is clear that a decline to below 100% has almost certainly been inevitable and evident to merchants and other observers, at least since Khartoum aid was suspended last year by Libya and Kuwait. Yet no flight from the dinar has developed.

* *At the Khartoum Conference in September 1967, Saudi Arabia, Kuwait, and Libya agreed to provide $41 million, $39 million, and $25 million a year, respectively, to Jordan until the West Bank was recovered from Israel.*

7. Holders of large dinar balances probably are more concerned with the absolute level of foreign exchange reserves and the balance of payments than they are with the ratio of foreign exchange to currency. Although foreign exchange reserves have declined since 1968, they are still relatively high -- equivalent to the value of 16 months' imports at the 1969 rate -- and the decline has been less than 10% over the two-year period. So long as foreign exchange reserves are high enough to make continued free convertibility of the dinar a near certainty for some time, there should be little reason for a flight of capital.

8. The decline in foreign exchange reserves in 1971 could be substantial enough to affect public willingness to hold dinars late in 1971 or in 1972. Even the optimistic projection by the IMF shows foreign exchange reserves declining about 20% during 1971. A decline of this magnitude would reduce Jordan's reserves to the equivalent of 12 months' imports at the level projected for the current year -- still a very respectable reserve level. However, if Kuwait, as well as Libya, continues to withhold its aid and Jordan receives no new financial assistance from other sources, reserves could decline as much as 40% in 1971, or by $100 million. Such a drop would almost certainly lead to strong speculation against the dinar.

9. A revival of public confidence and economic activity, which were hurt by the fighting with the fedayeen, could cause a further deterioration in the balance of payments. In 1969, relative tranquility and prosperity led to an 18% increase in imports. Since that time, liquidity has increased while inventories of goods and reserves of foreign exchange have declined, rendering the economy more vulnerable. The situation is made still less tractable by Israeli control of the West Bank, where commerce with Israel -- including employment of West Bank residents in Israel at high wages -- already is exerting inflationary pressures. The Jordanian government can do little to control aggregate demand on the West Bank.

10. A variety of measures might be adopted to stem a foreign exchange outflow. The dinar could be devalued, duties raised, quota and licensing

schemes imposed on imports, and limits placed on the amount of dinars allowed to be converted into other currencies or taken out of the country. Devaluation could result in cutting real incomes, but might have little impact on the volume of trade. Controls on transactions between the West Bank and foreign countries could not be enforced, and Jordan would find it politically difficult to impose controls on transactions between the East and West Banks.

Conclusions

11. It seems almost certain that the ratio of foreign exchange to Jordanian currency will fall below 100% this year. The expected budget deficit and other factors will likely result in an increase of about $40 million in the amount of currency in circulation. At the same time, the balance-of-payments deficit is expected to cause a $50 million drawdown in foreign exchange reserves, which are now about $250 million, even if Arab aid continues to be received at the same level as last year. Arab aid, however, is likely to decline. Both Libya and Kuwait suspended aid payments last year and, while Kuwait's payments may be restored this year, under present circumstances Libya's almost certainly will not. If neither country supplies aid this year, foreign reserves could drop as much as $100 million. This suggests that Jordan would require something on the order of about $150 million in foreign aid to maintain a 100% currency cover.

12. The ratio of foreign exchange to currency is, of itself, relatively unimportant, and its decline below 100% probably would have little immediate consequence. The level of foreign exchange reserves, however, is important to confidence in the dinar and to Jordan's ability to sustain economic viability. A sizable reduction of reserves could have severe repercussions. Although the current level of reserves seems high, it is declining; the amount of dinars that could be dishoarded suddenly is very great; the potential for rapid expansion of domestic production to meet an upsurge in demand (in the short run at least) is

very low; and large portions of Jordan's territory and of its currency frontier are not under the control of the Jordanian government. Jordan needs a relatively large reserve cushion -- larger than most less developed countries -- and a rapid draw-down of reserves could not safely be continued for long.